

EXHIBIT

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QUEST DIAGNOSTICS INC (DGX)

10-Q

Quarterly report pursuant to sections 13 or 15(d)

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549**

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2009
Commission file number 001-12215

Quest Diagnostics Incorporated

Three Giralda Farms
Madison, NJ 07940
(973) 520-2700

Delaware
(State of Incorporation)

16-1387862
(I.R.S. Employer Identification Number)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Accelerated filer ☐

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

As of July 22, 2009, there were 185,747,242 outstanding shares of the registrant's common stock, \$.01 par value.

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(in thousands, unless otherwise indicated)
(unaudited)

For the three and six months ended June 30, 2008, the Company reissued 0.3 million shares and 0.7 million shares, respectively, for employee benefit plans. The Company did not purchase any shares of its common stock during the three or six months ended June 30, 2008.

7. SUPPLEMENTAL CASH FLOW & OTHER DATA

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Depreciation expense	\$ 55,811	\$ 57,509	\$ 111,665	\$ 113,504
Interest expense	(36,961)	(46,876)	(76,805)	(96,521)
Interest income	115	1,444	551	3,472
Interest expense, net	(36,846)	(45,432)	(76,254)	(93,049)
Interest paid	29,720	40,702	76,857	99,631
Income taxes paid	136,153	168,371	167,500	193,213

8. COMMITMENTS AND CONTINGENCIES

The Company has a line of credit with a financial institution totaling \$85 million for the issuance of letters of credit (the "letter of credit line"). The letter of credit line, which is renewed annually, matures on November 19, 2009 and is guaranteed by certain of the Company's domestic, wholly-owned subsidiaries (the "Subsidiary Guarantors").

In support of its risk management program, to ensure the Company's performance or payment to third parties, \$74 million in letters of credit were outstanding at June 30, 2009. The letters of credit primarily represent collateral for current and future automobile liability and workers' compensation loss payments. In addition, \$5.4 million of bank guarantees were outstanding at June 30, 2009 in support of certain foreign operations.

Contingent Lease Obligations

The Company is subject to contingent obligations under certain leases and other instruments incurred in connection with real estate activities and other operations associated with LabOne, Inc., which the Company acquired in 2005, and certain of its predecessor companies. No liability has been recorded for any of these potential contingent obligations. See Note 14 to the Consolidated Financial Statements contained in the Company's 2008 Annual Report on Form 10-K for further details.

Legal Matters

The Company is involved in various legal proceedings. Some of the proceedings against the Company involve claims that are substantial in amount.

NID Investigation

On April 15, 2009, the Company finalized the resolution of the previously disclosed federal government investigation related to NID, a test kit subsidiary voluntarily closed in 2006, and entered into a final settlement agreement with the federal government. Pursuant to the settlement agreement, in the second quarter of 2009, the Company paid \$268 million to settle the civil allegations. As part of the settlement agreement, the Company was released from all federal civil claims underlying the investigation and the United States Department of Health and

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Human Services agreed to refrain from seeking the Company's exclusion from Medicare, Medicaid or other federal healthcare programs. The Company also entered into a five-year corporate integrity agreement with the Office of Inspector General for the United States Department of Health and Human Services. In addition, NID pled guilty to a single count of felony misbranding and paid a \$40 million fine. These second quarter payments totaling \$308 million, which had been previously reserved, were funded out of cash on-hand and available credit facilities. The Company also expects to enter into separate settlement agreements with certain states totaling approximately \$6 million which are fully reserved for.

In June 2009, a shareholder plaintiff filed a purported derivative action in the Superior Court of New Jersey, Morris County, on behalf of the Company against certain present and former directors and officers of the Company based on, among other things, their alleged breaches of fiduciary duties in connection with the manufacture, marketing, sale and billing related to certain test kits manufactured by NID. The complaint includes claims for, among other things, breach of fiduciary duty and waste of corporate assets and seeks, among other things, damages and remission of compensation received by the individual defendants.

Other Matters

The Company has in the past entered into several settlement agreements with various government and private payers relating to industry-wide billing and marketing practices that had been substantially discontinued. The federal or state governments may bring additional claims based on new theories as to the Company's practices which management believes to be in compliance with law. In addition, certain federal and state statutes, including the qui tam provisions of the federal False Claims Act, allow private individuals to bring lawsuits against healthcare companies on behalf of government or private payers alleging inappropriate billing practices. The Company is aware of certain pending lawsuits, including a class action lawsuit, and has received several subpoenas related to billing practices.

During the second quarter of 2005, the Company received a subpoena from the United States Attorney's Office for the District of New Jersey. The subpoena seeks the production of business and financial records regarding capitation and risk sharing arrangements with government and private payers for the years 1993 through 1999. Also, during the third quarter of 2005, the Company received a subpoena from the United States Department of Health and Human Services, Office of the Inspector General. The subpoena seeks the production of various business records including records regarding the Company's relationship with health maintenance organizations, independent physician associations, group purchasing organizations, and preferred provider organizations relating back to as early as 1995. The Company is cooperating with the United States Attorney's Office and the Office of the Inspector General.

In 2006 and 2008, the Company and several of its subsidiaries received subpoenas from the California Attorney General's Office seeking documents relating to the Company's billings to MediCal, the California Medicaid program. The Company cooperated with the government's requests. Subsequently, the State of California intervened as plaintiff in a civil lawsuit, *California ex rel. Hunter Laboratories, LLC v. Quest Diagnostics Incorporated, et al.*, filed in California Superior Court against a number of clinical laboratories, including the Company and several of its subsidiaries. The complaint alleges overcharging of MediCal for testing services. The complaint was originally filed by a competitor laboratory in California under the whistleblower provisions of the California False Claims Act. The complaint was unsealed on March 20, 2009.

In April 2009, the Company and certain of its subsidiaries received a subpoena from the Virginia Attorney General's Office seeking documents related to the Company's billings to the Virginia Medicaid program. The Company is cooperating with the request.

The Company understands that there may be other pending qui tam claims brought by former employees or other "whistle blowers" as to which the Company cannot determine the extent of any potential liability. The Company also is aware of certain pending individual or class action lawsuits related to billing practices filed under the qui tam provisions of the Civil False Claims Act and/or other federal and state statutes, regulations or other laws.

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Several of these other matters are in their early stages of development and involve responding to and cooperating with various government investigations and related subpoenas. While the Company believes that at least a reasonable possibility exists that losses may have been incurred, based on the nature and status of the investigations, the losses are either currently not probable or cannot be reasonably estimated.

Management has established reserves in accordance with generally accepted accounting principles for the other matters discussed above. Such reserves totaled less than \$5 million as of June 30, 2009. Although management cannot predict the outcome of such matters, management does not anticipate that the ultimate outcome of such matters will have a material adverse effect on the Company's financial condition but may be material to the Company's results of operations or cash flows in the period in which the impact of such matters is determined or paid. In addition, there may be pending qui tam claims brought by former employees or other "whistle blowers," or other pending claims as to which the Company has not been provided with a copy of the complaint and accordingly cannot determine the extent of any potential liability.

As a general matter, providers of clinical testing services may be subject to lawsuits alleging negligence or other similar legal claims. These suits could involve claims for substantial damages. Any professional liability litigation could also have an adverse impact on the Company's client base and reputation. The Company maintains various liability insurance coverage for claims that could result from providing or failing to provide clinical testing services, including inaccurate testing results and other exposures. The Company's insurance coverage limits its maximum exposure on individual claims; however, the Company is essentially self-insured for a significant portion of these claims. Reserves for such matters are established by considering actuarially determined losses based upon the Company's historical and projected loss experience. Management believes that present insurance coverage and reserves are sufficient to cover currently estimated exposures. Although management cannot predict the outcome of any claims made against the Company, management does not anticipate that the ultimate outcome of any such proceedings or claims will have a material adverse effect on the Company's financial condition but may be material to the Company's results of operations or cash flows in the period in which the impact of such claims is determined or paid.

9. DISCONTINUED OPERATIONS

During the fourth quarter of 2005, NID instituted its second voluntary product hold within a six-month period due to quality issues, which adversely impacted the operating performance of NID. As a result, the Company evaluated a number of strategic options for NID. On April 19, 2006, the Company decided to discontinue NID's operations. During the third quarter of 2006, the Company completed its wind down of NID and classified the operations of NID as discontinued operations. Results of operations for NID have been reported as discontinued operations in the accompanying consolidated statements of operations and related disclosures for all periods presented.

During the third quarter of 2007, the government and the Company began settlement discussions with respect to the government's investigation involving NID and the Company. Based on the status of settlement discussions, during 2007 the Company established a reserve, in accordance with generally accepted accounting principles, reflected in discontinued operations, of \$241 million in connection with these claims.

During the third quarter of 2008, the Company and NID reached an agreement in principle with the United States Attorney's Office to settle the federal government investigation involving NID and the Company regarding NID test kits and tests performed using those test kits. As a result of the agreement in principle in 2008, the Company recorded charges of \$75 million in discontinued operations to increase its reserve for the settlement and related matters.

On April 15, 2009, the Company finalized the resolution of the federal government investigation related to NID and entered into a final settlement agreement with the federal government. In the second quarter of 2009, the Company paid \$268 million to settle the civil allegations. In addition, NID pled guilty to a single count of felony misbranding and paid a \$40 million fine. These second quarter payments totaling \$308 million, which had been previously reserved, were funded out of cash on-hand and available credit facilities. The Company also

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expects to enter into separate settlement agreements with certain states totaling approximately \$6 million which are fully reserved for. See Note 8 for further details.

Summarized financial information for the discontinued operations of NID is set forth below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net revenues	\$ —	\$ —	\$ —	\$ —
Income (loss) from discontinued operations before income taxes	148	(1,500)	(2,672)	(3,093)
Income tax (expense) benefit	(60)	610	1,089	1,116
Income (loss) from discontinued operations, net of taxes	\$ 88	\$ (890)	\$ (1,583)	\$ (1,977)

At June 30, 2009 and December 31, 2008, the settlement reserve totaling \$7 million and \$316 million, respectively, is included in "accounts payable and accrued expenses" in the consolidated balance sheet. The deferred tax asset recorded in connection with establishing the reserve of \$58 million is included in "deferred income taxes" in the consolidated balance sheet at December 31, 2008. The remaining balance sheet information related to NID was not material at June 30, 2009 and December 31, 2008.

10. BUSINESS SEGMENT INFORMATION

Clinical testing is an essential element in the delivery of healthcare services. Physicians use clinical tests to assist in the detection, diagnosis, evaluation, monitoring and treatment of diseases and other medical conditions. Clinical testing is generally categorized as clinical laboratory testing and anatomic pathology services. Clinical laboratory testing is performed on blood and body fluids, such as urine. Anatomic pathology services are performed on tissues, such as biopsies, and other samples, such as human cells. Customers of the clinical testing business include patients, physicians, hospitals, employers, governmental institutions and other commercial clinical laboratories. The clinical testing business accounted for greater than 90% of net revenues from continuing operations in 2009 and 2008.

All other operating segments include the Company's non-clinical testing businesses and consist of its risk assessment services business, its clinical trials testing business, its healthcare information technology business, MedPlus and its diagnostics products businesses. The Company's risk assessment business provides underwriting support services to the life insurance industry including teleunderwriting, paramedical examinations, laboratory testing and medical record retrieval. The Company's clinical trials testing business provides clinical testing performed in connection with clinical research trials on new drugs and vaccines. MedPlus is a developer and integrator of clinical connectivity and data management solutions for healthcare organizations, physicians and clinicians. The Company's diagnostics products business manufactures and markets diagnostic test kits.

On April 19, 2006, the Company decided to discontinue NID's operations and results of operations for NID have been classified as discontinued operations for all years presented (see Note 9).

At June 30, 2009, substantially all of the Company's services are provided within the United States, and substantially all of the Company's assets are located within the United States.

The following table is a summary of segment information for the three and six months ended June 30, 2009 and 2008. Segment asset information is not presented since it is not reported to or used by the chief operating decision maker at the operating segment level. Operating earnings (loss) of each segment represents net revenues less directly identifiable expenses to arrive at operating income for the segment. General management and administrative corporate expenses, including amortization of intangible assets, are included in general corporate

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expenses below. The accounting policies of the segments are the same as those of the Company as set forth in Note 2 to the Consolidated Financial Statements contained in the Company's 2008 Annual Report on Form 10-K and Note 1 to the interim consolidated financial statements.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net revenues:				
Clinical laboratory testing business	\$ 1,742,292	\$ 1,675,530	\$ 3,405,924	\$ 3,303,633
All other operating segments	159,526	162,371	303,900	318,905
Total net revenues	<u>\$ 1,901,818</u>	<u>\$ 1,837,901</u>	<u>\$ 3,709,824</u>	<u>\$ 3,622,538</u>
Operating earnings (loss):				
Clinical laboratory testing business	\$ 393,524 (a)	\$ 337,938	\$ 736,935 (a)	\$ 643,902
All other operating segments	20,302	14,050	33,165	22,692
General corporate expenses	(54,451)	(43,865)	(89,662)	(78,210)
Total operating income	<u>359,375</u>	<u>308,123</u>	<u>680,438</u>	<u>588,384</u>
Non-operating expenses, net	<u>(37,559) (b)</u>	<u>(37,292)</u>	<u>(71,106) (b)</u>	<u>(77,947)</u>
Income from continuing operations before income taxes	<u>321,816</u>	<u>270,831</u>	<u>609,332</u>	<u>510,437</u>
Income tax expense	<u>123,535</u>	<u>100,787</u>	<u>233,724</u>	<u>192,645</u>
Income from continuing operations	<u>198,281</u>	<u>170,044</u>	<u>375,608</u>	<u>317,792</u>
Income (loss) from discontinued operations, net of taxes	<u>88</u>	<u>(890)</u>	<u>(1,583)</u>	<u>(1,977)</u>
Net income	<u>198,369</u>	<u>169,154</u>	<u>374,025</u>	<u>315,815</u>
Less: Net income attributable to noncontrolling interests	<u>10,169</u>	<u>7,826</u>	<u>18,723</u>	<u>14,880</u>
Net income attributable to Quest Diagnostics	<u>\$ 188,200</u>	<u>\$ 161,328</u>	<u>\$ 355,302</u>	<u>\$ 300,935</u>

(a) For the three and six months ended June 30, 2009, operating income includes a \$15.5 million gain associated with an insurance settlement for storm related losses.

(b) For the three and six months ended June 30, 2009, non-operating expenses, net includes a \$7.0 million charge related to the write-off of an investment and a \$6.3 million loss on the early extinguishment of debt (see Note 5 for further details).